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McGuire v. More-Gas Invs., LLC

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McGuire v. More-Gas Invs., LLC (2013) 220 CA4th 512

We recently had a decision that held that while a clause in a real estate contract failed as a liquidated damage provision, it nevertheless might work as one for alternative performance. So I wrote a column on it.

Liquidated Damages or Alternative Performance?

There are many conclusions to draw from reading *McGuire v More-Gas Invs., LLC* (2013) 220 CA4th 512, although I think that those conclusions are ultimately outnumbered by the questions the opinion raises. In two different situations, the seller of land had promised the buyers that it would complete the task of obtaining some necessary entitlements, after the escrows had closed, and had then failed to keep those promises.

What makes the situation interesting is that both contracts not only provided for these additional acts of belated performance by the seller, but also provided for the particular remedies the buyers were to have if that performance was not rendered. The issue in the trial and appellate courts was not the enforceability of the seller's original promises to convey and later obtain the entitlements, but rather the enforceability of the contractual stipulations about the extent of the seller's liability if it failed to perform those original promises.

The facts are more fully described at p. 13 of this issue, so only the essential ones will be repeated here. There were two separate deals. In the Orchard deal, the buyers were paying $1.05 million for two parcels. The contract required the seller also to obtain view-preserving CC&Rs from neighbors within two months after close of escrow *or else refund $80,000 of the purchase price to the buyers*. In the Jahant deal, the same buyers were paying $2 million for five parcels. The seller was additionally required to obtain a final subdivision map within 12 months of closing *or else purchase the parcels back from the buyers for $2.5 million, $500,000 more than it had received*. Although the remedial mechanisms were different—a refund in Orchard versus a buyback in Jahant—the court of appeal thought that they entailed the same underlying issue. "Whether the money was to be held back and never paid ... or paid and then refunded ... the substance of the deal is the same in both instances."-220 CA4th at 528. Thus, overall, the seller had obliged itself to pay the buyers $80,000 in one case and $500,000 in the other if it did not perform the post-closing obligations it had undertaken.

The seller did not perform and the buyers sued for the $580,000 provided for under these two contracts. The trial court granted summary judgment to the sellers, holding that those special provisions were both invalid, but the court of appeal thought somewhat otherwise, which I will explore after I dispose of some preliminary issues.

The Contract Obligations and Statutory Damages

Although these disputes arose in the context of a vendor-purchaser transaction, the breaches did not consist of nonperformance of a vendor's obligation to convey a good title to the purchaser. That sort of standard, run-of-the-mill breach triggers a statutory measure of damages equal to the difference between the contract price and the market value at breach date, plus incidentals. CC §3306.-The companion rule in CC §3305-provides a reverse mirror-image measure when the purchaser commits the even more common breach of failing to pay the purchase price. In *More-Gas*, the buyers and seller both did perform the conveyancing components of their contracts. What was unperformed were the separate ancillary promises by the seller to procure restrictive covenants on Orchard and final subdivision map approval on Jahant. For those breaches, it was probably not §3306 that applied, but rather the general measure of damages provided by CC §3300, "the amount which will compensate the party aggrieved for all the detriment proximately caused thereby, or which, in the ordinary course of things, would be likely to result therefrom."-The appropriate background measure of damages—*i.e.,* what would apply if the special provisions failed—was not mentioned in any of the briefs, so my conclusions are somewhat speculative.

If the $80,000 and/or $500,000 provisions are held invalid, the buyers will have to prove their damages by conventional means. I guess that, for the Orchard case, they would call a broker or appraiser to opine how much less the two lots were worth because of their obstructed views. For Jahant, they might do the same or, alternatively, bring in a developer or facilitator to opine as to how much it might cost to obtain a final subdivision map. (I doubt that there would be any alternative relief sought, since performance—especially in Orchard—is likely impossible, since the seller was clearly unable to perform its promises, and relief by way of rescission would only return the buyers' payments to them, much less than they manifestly wanted.) The cost of substituted performance or the loss of value due to nonperformance should constitute "all of the detriment proximately caused" for the seller's failure to procure the entitlements.

Liquidated Damages

The actual contracts replaced "all the detriment" with $80,000 and $500,000 as the measure of the buyers' recovery; *i.e.,* it appeared to liquidate their damages.-But courts often show a reluctance about letting the parties create their own measure of damages; judges appear to prefer the statutory measure—even when its generality makes proof at trial significantly more complicated than use of the stipulated sum would. Courts appear willing to allow the counterparties to promise almost anything they want,

regardless of its realism or unrealism, as far as the underlying performance is concerned. But with regard to the sanctions that will be imposed for nonperformance of those underlying promises, those same courts are much less tolerant.

Until 1978, our general rule invalidated liquidated damages provisions except when their proponent could demonstrate that actual damages were too hard to measure. Civil Code §1671 used to permit them only "when, from the nature of the case, it would be impracticable or extremely difficult to fix the actual damage." I doubt very much that any court would have found actual damages (as described above) too difficult to measure.

Since 1978, that standard has been replaced with a much more tolerant one, which provides that the provision "is valid unless the party seeking to invalidate the provision establishes that the provision was unreasonable under the circumstances existing at the time the contract was made." While there are statutory carveouts for consumer purchases and residential leases, the *McGuire* contracts would have easily come under the new general standard of presumptive validity.

However, the trial court rejected both of the provisions, holding that they constituted unenforceable penalty arrangements rather than valid liquidated damage amounts.- While the trial court's grant of summary judgment was ultimately reversed, its underlying holdings on liquidated damages were left intact.

A first lesson to learn from this case is to figure out why those provisions failed as liquidated damages provisions, so that drafters will not make the same mistakes in their future contracts. The buyers in *McGuire* not only had a statutory presumption of reasonableness on their side, but also benefited from the fact that it was the defendant seller who moved for summary judgment, which automatically imposed the burden of persuasion on it; their loss occurred despite having a presumption and the burden of proof working for them—which speaks ominously for future successful drafting.

The buyers appear to have lost on the issue of liquidated damages by admitting on deposition that, as to Orchard, they did "not remember how the [$80,000] figure was determined" and "did not do any market research to determine diminution of value." Regarding Jahant, the buyers testified that they "never gave any consideration to the value of the property" without subdivision approval, and "did not recall how they came up with the $500,000," that amount being intended to operate as an "incentive to get the job done." It appears that while CC §1671 puts the burden of proving unreasonableness on the party resisting the liquidated damages provision, that unreasonableness can cover not only the dollar amount chosen but also the process by which it was reached.-Eighty thousand dollars may be a reasonable amount of liquidated damages on a $1 million contract (it amounted to 8 percent of the price, whereas 10 percent is acceptable in New York), but that is not sufficient proof of reasonableness when the benefiting party admits that the number was drawn out of a

hat rather than thoughtfully derived as a close approximation of the compensation it will need if the deal fails.

That says to me that when a client has successfully negotiated for a liquidated damages provision, the attorney has the following jobs:

- In drafting the provision, making sure the contract includes recitals or other language showing why the number settled on has some intelligible relationship to what actual losses might be (as well as, to be safe under the old standard, why leaving the outcome to statutory calculation is unworkable or unsatisfactory).
- In litigating the provision, making sure the clients do not to throw away the benefits of the negotiating and drafting processes by careless testimony.

As a closing comment on liquidated damages, note that CC §§1675–1679, adding requirements of large print, separate initials, and +/-3 percent standards, are inapplicable to this sort of case because they do not involve a buyer failing to complete the purchase and facing forfeiture of the deposit. But those standards must be attended to when the circumstances fit, and might wisely be followed even when they don't fit.

Alternative Performance

The court of appeal reversed the trial court for not determining whether the $80,000 and $500,000 provisions amounted to valid alternative performance arrangements while it was, at the same time, endorsing the lower court's treatment of those provisions as invalid liquidated damages clauses. That seems to me to amount to telling the bar that different considerations apply to those two issues. Clauses that are held to violate liquidated damages standards apparently may, notwithstanding, be treated as enforceable alternative performance arrangements (or perhaps vice versa—as long as the provision is upheld, it may not matter which doctrine justifies it). So this opinion should be studied to learn what it takes to create an effective alternative performance arrangement, because we don't see many of those creatures around.

Judicial scrutiny of the liquidated damages arrangement seemed to focus on the reasoning of the party attempting to collect those damages: The buyers lost because they did not explain how they had arrived at the liquidated amounts. Conversely, it looks to me like attention is instead paid to the "breacher's" reasoning when a court is deciding whether real alternative performance is involved. The court of appeal remanded the case to the trial court to determine whether the parties' arrangements gave the seller "realistic and rational" choices. (In Orchard, it was "whether the choice between securing the desired amendment to the CC&Rs or giving back $80,000 was a realistic and rational choice when viewed from the time of making the contract." In Jahant, it was "whether the choice between finishing the subdivision or giving plaintiffs the option of forcing More-Gas to repurchase the property at a $500,000 repurchase premium could have been viewed as a realistic and rational choice for More-Gas in

August 2006.")-A standard requiring that the defendant have a "realistic and rational choice" appears to replace the standard that the plaintiff show a "reasonable relationship to actual damages" when a court is considering alternative performance rather than liquidated damages.

How does one show compliance with a "realistic and rational choice" standard? Referring to the Jahant transaction, the appellate court said (220 CA4th at 532):

> For example, there is no evidence of what the parties could have reasonably expected, at the time they entered into the Jahant addendum, that it would cost More-Gas to finish the subdivision and get the final map recorded. Absent such evidence—and whatever other evidence might be material to the point—we have no basis for judging.

If showing the anticipated cost of performance is what had to be shown, that still leaves hanging how knowing that number would resolve the issue. If the requirement is that the number be in the same order of magnitude as the stipulated $500,000, then how is this alternative performance standard different from the reasonable forecast requirement for liquidated damages?-(And if the standards are in fact the same, then wouldn't the trial court's original findings have settled both questions?)

Equally puzzling is the question of what evidence ought to be presented or considered over and above an ex ante estimate of costs. What testimony could the plaintiff buyers offer on their side that would help a trier of fact make a decision on the realism or rationality of a choice that is to be made by the defendant seller, rather than by them? (Which is a choice that the seller would probably make later, when the time for performance came due, rather than the earlier moment of making the agreement.) If a seller is allowed to testify subjectively about how he appraised his options, how is such testimony to be weighed in light of the obvious dangers that it was colored by hindsight and trial coaching? Must the defendant produce actual calculations, or may he simply testify as to what he privately believed the cost to him of the alternative was? If there is an integration clause in the contract, how much of this testimony would be allowed in?

As for drafting the alternative performance provision, after the attorneys have been given the numbers negotiated by the parties, should they attempt to bolster the clause self-proving by identifying the appointed number as a freely reached realistic and/or rational choice? Should their contract attempt to fortify that conclusion by pricing and weighing some rejected alternatives?

Also uncertain to me is the extent to which attempts to defend the provision as alternative performance might get in the way of having it upheld as liquidated damages instead.-Can the provision say that it functions as both types of arrangement, or that alternative performance also means alternative to liquidated damages?

The only safe conclusion I can draw is that the propounding party ought to be careful not to identify the stipulated amount as a "penalty." That is the one alternative you do want to avoid.

37 Real Property Law Reporter 10 (Cal CEB January 2014)